

**PUBLIC COMMENTS RECEIVED ON THE DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS –
PART II (SPECIAL CONSIDERATIONS FOR APPLYING THE WORKING HYPOTHESIS TO PERMANENT ESTABLISHMENTS OF BANKS)**

European Banking Federation

1. The Banking Federation of the European Union (EBF)¹, which represents the interests of some 3,000 banks in the EU and in Iceland, Norway and Switzerland, encloses herewith its response on the OECD discussion draft, which was released in February 2001 and which is set forth as a working hypothesis (WH) of an appropriate method for attributing profits to Permanent Establishments (PEs) under Article 7 of the QEOD Model Tax Convention. The EBF comments set forth below include observations on both Part I and Part II of the OECD discussion draft, but they primarily focus on Part II, which concerns the traditional banking activities, i.e. the raising and on-lending of money. The EBF also looks forward to being able to comment on Part III concerning global trading when this becomes available.

2. The EBF supports the efforts made by the OECD with a view to creating a level playing field in the application of methods for attributing profits to PE's for tax purposes, as far as this process is dedicated to improving the avoidance of double taxation.

3. Nevertheless, the EBF has a number of significant reservations as to the practicalities of the proposed method and serious concerns about the degree of complexity and associated compliance costs involved in the working hypothesis. In this context, the EBF urges the OECD to adopt a flexible and pragmatic approach, with the aim of avoiding double taxation, leading to an easily manageable, auditable and consistent system.

4. Having said that, the EBF assumes that the OECD discussion paper is a first step of what it considers should be a longer process involving the establishment of a technical advisory group (TAG), to be carried on over an extended period of study, in order to arrive at an acceptable and workable solution.

5. Accordingly, the EBF calls for no immediate action to be taken before all aspects have been fully worked out. The EBF would also stress that the need for a level playing field means that national tax authorities should not undertake any individual action before any consensus has emerged at OECD level.

6. Moreover, the OECD should bear in mind the integrated nature of banking activities and portfolio risk management and should pay attention to the difficulties that could arise from any segregation of activities. In this connection, the EBF presumes that the same or a similar working hypothesis will be applied *mutatis mutandis* to traditional banking activities and global trading.

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Part I of the OECD Discussion Paper

7. The EBF understands the OECD preference for a “functionally separate entity approach” as a basis of the working hypothesis, given that this approach has become accepted through the international tax doctrine. This means that a PE would be treated as if it were a distinct and separate enterprise. The EBF specifically notes the recognition, implied by this working hypothesis, of the ability of a PE to transact, e.g. to sell an asset, with another part of the legal entity, i.e. to operate “intra-branch dealings”. Thus, the profits would be attributed to the PE according to the “arm’s length principle” stipulated in Article 7, § 2. Therefore, the profits that would be attributable to the PE and hence taxed in the host country would be in principle the profits that the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

8. However, the arm’s length principle is practically impossible to apply in some cases, so it is necessary in those cases to depart from the “functionally separate entity approach”.

9. Nevertheless the EBF welcomes the reaffirmation that the profits attributed to the PE do not extend to profits that the enterprise may derive from that State other than through the PE. This means that no “force of attraction” principle is applicable.

10. It is understood that the working hypothesis provides for a 2-step approach with a view to attributing profits to a PE according to the aforementioned principles:

- firstly, a “factual and functional analysis” is applied, whereby assets used, functions performed and risks assumed are attributed to the PE;
- secondly, a “comparability analysis” is carried on, whereby profits are attributed to intra-branch dealings by reference to comparable transactions between independent enterprises and according to the guidance in OECD Transfer Pricing Guidelines, which are applied by analogy.

11. However, as the report itself acknowledges, this 2-step approach is very difficult to apply consistently and is impossible to apply in certain circumstances. Accordingly the EBF is of the opinion that the working hypothesis should be regarded with a flexible degree of pragmatism, so as to arrive at what the EBF considers as the main objective of the process, i.e. the avoidance of double taxation with an easily manageable, auditable and consistent system.

12. In this spirit, the EBF considers that the existing treatment of Head Office (HO) costs in particular should not be changed, given that the current system works reasonably well in practice. Actually, the paper suggests that a mark up might be appropriate for Head Office costs in certain circumstances, considering that they are similar to third party services and that they should be charged accordingly. However there is a greater degree of integration between branches and Head Office than between parent and subsidiary and to alter the present approach would bring in an unnecessary degree of artificiality.

Part II of the OECD Discussion Paper

Allocating assets to the PE

13. The EBF has significant reservations about the OECD proposal of allocating assets according to where these assets are used. The proposed approach means that most assets would be split according to the different functions performed. This would require undertaking a detailed analysis of a very large number of

transactions and for these to be tracked over time. Unless a reasonable degree of approximation is allowed then it would in practice be very difficult to administer. In addition, as regulatory standards do not require such a geographic allocation of financial assets, this would necessitate the creation and maintenance of separate tax records, with consequent implications for compliance costs. Besides we fear an increase in mutual agreement procedures, as such separate tax records might not be accepted by all tax authorities involved. Therefore, the EBF suggests the alternate solution of attributing the assets to PE's where they are booked. Consequently the attribution of assets to PEs could be the first stage of the process of attributing profits to the PE, ahead of the attribution of functions.

14. The EBF is of the opinion that on balance sheet items should be recognised, whilst off balance sheet items should be ignored. In order to avoid double counting, the EBF considers in addition that only external assets should be recognised. Thus a branch that would only act as a deposit taker with all the funds lent back to its Head Office would be considered as having no assets.

15. We see no compelling reasons for any change to existing practice for intangible assets. In particular we question whether any meaningful value can be attributed to marketing intangible represented by the name, reputation, trademark or existing logo of a bank. Accordingly the EBF considers that the current treatment of intangibles should not be changed.

Attributing functions to the PE

16. Whilst accepting the underlying logic of the functional analysis the EBF fears that functions would be difficult to segregate and that the approach would be difficult to apply in practice. It is also unclear what "weight" should be given to the various factors involved and hence what their reward should be.

17. Notwithstanding this, the EBF considers that functions to take into consideration must notably include the function involved in creating new financial assets, the function involved in assuming and managing risk, which we consider is the key driver of profitability, and the back office function, notably dedicated to book the assets.

Attribution of credit rating

18. Whilst the EBF considers that, as a simplified assumption, it is a departure from the theoretical basis of a hypothesised distinct and separate enterprise, we agree that the presumption of a single credit rating for the bank as a whole is appropriate and should apply in all cases.

Attribution of free capital

19. A central aspect of the working hypothesis is the allocation to the PE of "free capital", which the paper defines as contributions of equity by shareholders and retained profits. It also refers to tier 1 capital and tier 2 capital and in general assumes that all tier 1 capital is free capital whereas all tier 2 capital is not free capital. This needs clarification.

20. The working hypothesis provides for a 2-step approach as a proxy for an allocation of capital to the PE's:

- a Basle standardised approach is applied in order to risk weight the assets;

- the capital of the bank is allocated pro rata to the risk weighted assets (BIS ratio approach).

21. The EBF has major concerns about the proposed approach.

22. Firstly, there are currently discussions to amend the Basel Capital Accord, which may put more emphasis on operational risk as a driver for capital requirements. Thus it is likely that it would be more difficult in the context of the new Accord to apply a Easel standardised approach as a proxy for allocating capital to a PE under arm's length principle. In this connection it would not be acceptable to re-think the application of Article 7 of the OECD Model Tax Convention by reference to regulatory considerations before the new Basel risk measurement approach is adopted.

23. The working hypothesis also proceeds on the basis that there is only one clear set of Basle rules being applied. In practice national regulators apply some discretion and hence there are variations from country to country. Therefore, we consider that, if the working hypothesis would rely on any regulatory standards, they should be those applied by the home country regulator.

24. We also wish to point out that Basel standards take into account off-balance sheet items and that taking into account off-balance sheet exposures in computing the relative amount of risk weighted assets attributable to each branch could produce distorted results (for tax purposes).

25. It should also be borne in mind that Basel ratios are computed and audited in the home country. Accordingly the EBF cannot accept any requirement of computing Basel ratios at the level of the PE in the host country for tax purposes.

26. Thus the EBF rejects the Basel approach and considers that the starting point of the attribution of capital must be the financial figures of the bank, audited by the external auditors of the legal entity and by the regulators of the home country. A possibility to be further investigated could consist in using the following ratio:

booked branch assets/
total financial assets based on financial books audited in the home country

27. An allocation to a PE of actual capital may be a departure from the arm's length principle but in principle we agree that this represents a reasonable approximation. Indeed, we agree that it would be inappropriate to allocate the Basle minimum, as most banks will operate at a level in excess of that minimum and it would be unfair to allocate all the excess to Head Office. However any excess may reflect a number of factors and in certain cases it might be hard to see why the benefit of a temporary excess should be allocated to PE, as this is likely to derive from Head Office plans with no relevance to its PE's as hypothesised distinct and separate enterprises.

28. We note that the working hypothesis appears to assume that no capital will in fact been allocated to a PE and hence proceeds on the basis of a disallowance of interest charged locally to a PE. Where capital has been allocated to a PE in excess of the pro rata amount we presume that it would equally follow that an additional local deduction would be allowed to reflect this. We are also unclear as to the situation where the PE is wholly funded locally and has no funding from its Head Office.

29. The OECD paper does not deal with the deductions from capital that may arise from Head Office decisions and that might thus be attributed to the Head Office on any functional analysis, so it would be the net capital that would therefore be allocated.

30. The paper proposes alternative means of "cleansing" the capital allocation. This needs to be examined by the Technical Advisory Group.

31. Once the whole of the net capital has been allocated any adjustment for tax deductibility might then be made on the basis of the tax regime applicable in the host country. This also needs to be examined by the TAG.

32. The paper refers to the implications of 'solo-consolidation' for capital adequacy regulatory purposes to the proposed tax treatment. Some EBF members (in Member States where this is relevant) point out that in the absence of the prudential treatment being followed for tax, the deduction of the investment in non-consolidated subsidiaries would result in the 'solo' bank having little or no capital to allocate. The effect would therefore be that the various fiscs in the countries where the PE is located would be presented with no allocation of capital to underpin the activities of the PE. There would be a risk that this would not be accepted by the local fisc given the overriding logic of the working hypothesis that a hypothetically separate entity would have to have some capital to support its activities. In such cases the members of the EBF referred to above, recognise that it would be equitable for the regulatory position to be followed for tax.

33. We also would welcome further discussion as to the practicalities of the calculations involved. The paper provides no guidance as to how various important timing issues would be addressed. The EBF considers that these aspects should be carefully examined during the TAG process.